

# Audit

# Report



## OFFICE OF THE INSPECTOR GENERAL

PROPERTY, PLANT, AND EQUIPMENT ACCOUNTS ON  
THE FINANCIAL STATEMENTS OF THE DEFENSE  
LOGISTICS AGENCY BUSINESS AREAS OF THE  
DEFENSE BUSINESS OPERATIONS FUND FOR FY 1993

Report No. 94-149

June 28, 1994

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Department of Defense

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### **Acronyms**

CAD	Capitol Asset Database
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
FYDP	Future Years Defense Program



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202

June 28, 1994

MEMORANDUM FOR COMPTROLLER OF THE DEPARTMENT OF DEFENSE  
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING  
SERVICE  
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Property, Plant, and Equipment Accounts on the  
Financial Statements of the Defense Logistics Agency Business Areas of  
the Defense Business Operations Fund for FY 1993 (Report No. 94-149)

We are providing this report for your review and comments. Financial statement audits are required by the Chief Financial Officers Act of 1990. This report discusses financial reporting of the property, plant, and equipment accounts on the Defense Logistics Agency's FY 1993 financial statements. Comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request that the Comptroller of the DoD provide additional comments on Recommendation B. and associated monetary benefits by August 29, 1994.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Charles Hoeger, Audit Program Director, in our Philadelphia Office, at (215) 737-3881 (DSN 444-3881) or Mr. John Issel, Audit Project Manager, in our Columbus Office, at (614) 337-8009. The distribution of this report is listed in Appendix E. The audit team members are listed on the inside back cover.

*David K. Steensma*  
David K. Steensma  
Deputy Assistant Inspector General  
for Auditing

## **Office of the Inspector General, DoD**

**Report No. 94-149**  
(Project No. 3LD-2023)

**June 28, 1994**

### **PROPERTY, PLANT, AND EQUIPMENT ACCOUNTS ON THE FINANCIAL STATEMENTS OF THE DEFENSE LOGISTICS AGENCY BUSINESS AREAS OF THE DEFENSE BUSINESS OPERATIONS FUND FOR FY 1993**

#### **EXECUTIVE SUMMARY**

**Introduction.** The Chief Financial Officers Act of 1990 requires the annual preparation and audit of financial statements for revolving funds. The Defense Logistics Agency (DLA) division of the Defense Business Operations Fund (the Fund) is a revolving fund consisting of five business areas -- clothing factory, distribution depots, industrial plant equipment, reutilization and marketing, and supply management. The business areas were established to manufacture selected clothing articles; store and distribute supply items; control and maintain industrial plant equipment; dispose of excess and surplus materiel; and procure and sell supplies to DoD Components and other customers. The DLA reported an acquisition value of \$318.6 million, accumulated depreciation of \$122.3 million, and a net balance of \$196.3 million for property, plant, and equipment on the FY 1993 financial statements.

This audit is one of a series being conducted by the Inspector General, DoD, in response to the Chief Financial Officers Act of 1990. The audit was performed in conjunction with audits of the DLA division of the Fund's management data (Report No. 94-128), inventory accounts (Report No. 94-150), and fund balances with the Treasury accounts (Project No. 4LE-2001). The audits are part of a building block approach to provide audit coverage of the DLA division of the Fund.

**Objectives.** Our objectives were to determine whether the property, plant, and equipment account and associated depreciation accounts on the FY 1993 financial statements were presented fairly in accordance with generally accepted accounting principles. We were also to evaluate the internal control structure for the accounts and to assess compliance with applicable laws and regulations for those transactions and events that have a direct and material effect on the accounts.

**Audit Results.** DLA property, plant, and equipment account acquisition costs were materially understated by at least \$229.4 million. In addition, at least \$24.5 million in equipment assets were inaccurately reflected in the financial records. As a result, the financial statements were inaccurate (Finding A).

The useful life that DoD established for the depreciation of software programs did not properly match period expenses with revenues and overstated the cost of the Fund's operations. As a result, major software programs will be fully depreciated long before their economic life has expired, which would result in accelerating charges to military unit customers during a 5-year period (Finding B).

**Internal Controls.** The audit identified material internal control weaknesses in that controls were not effective to provide reasonable assurance that material misstatements in the property, plant, and equipment and associated depreciation accounts would be prevented or detected in a timely manner. See Part I for internal controls reviewed and Part II for a discussion on the weaknesses identified.

**Potential Audit Benefits.** We identified potential monetary benefits of about \$417 million during FYs 1995 to 2000, representing inappropriate acceleration of depreciation charges to the Fund's customers for only six of the many computer software systems under development in the DoD. Additionally, nonmonetary benefits include improved controls over DLA's financial reporting of real and personal property and the accuracy of financial data.

**Summary of Recommendations.** We recommended that the Director, DLA, establish procedures to more effectively identify and report capital assets and reconcile capital asset data provided to the Defense Finance and Accounting Service. We also recommended that the FY 1993 financial statements be revised to show the effect of capitalizing assets and the problems identified in the audit. Additionally, we recommended that the Comptroller of the DoD revise the depreciation policy for computer software programs to recognize costs over the estimated useful life of the programs.

**Management Comments.** DLA concurred with the recommendation to identify and report real property on its financial statements and the need to periodically reconcile property, plant, and equipment financial data with property records. However DLA and the Defense Finance and Accounting Service did not agree to revise the financial statements until FY 1994 because the FY 1993 statements had already been certified and published. The Deputy Comptroller (Financial Systems) agreed in principle to revise the capital asset guidance for depreciation of software programs and stated that the Defense Business Operations Fund Corporate Board was reviewing current policy. The Deputy Comptroller did not comment on the monetary benefits. The complete texts of managements' comments are in Part IV.

**Audit Response.** DLA and the Defense Finance and Accounting Service's agreement to disclose corrective actions taken in the FY 1994 financial statements is an acceptable alternative to our recommendation. The Deputy Comptroller's comments are responsive, but we request that the Deputy Comptroller provide an update of the Corporate Board's review of the depreciation of software programs. The Deputy Comptroller's comments are requested by August 29, 1994.

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This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

## **Part I - Introduction**

## **Introduction**

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## **Background**

The Chief Financial Officers Act of 1990 (Public Law 101-576) requires the DoD to prepare financial statements covering substantial commercial functions, revolving funds, and trust funds of DoD. Financial statements are expected to provide information to DoD program managers, the Congress, and the public, facilitating both effective allocation of resources and assessment of management performance and stewardship.

The Defense Logistics Agency (DLA) division of the Defense Business Operations Fund (DBOF) is a revolving fund and consists of five business areas -- the clothing factory, distribution depots, industrial plant equipment, reutilization and marketing, and supply management. The business areas were established to manufacture selected clothing articles; store and distribute supply items; control and maintain industrial plant equipment; dispose of excess and surplus materiel; and procure and sell supplies to DoD Components and other customers. The Defense Finance and Accounting Service (DFAS) maintains the official accounting records. Preparation of the FY 1993 financial statements was the joint responsibility of DLA and DFAS.

The Office of the Comptroller of the DoD issued "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," January 12, 1994. The guidance provides direction for the preparation and presentation of the FY 1993 financial statements required by the Chief Financial Officers Act. An audit report for the FY 1993 financial statements is required to be submitted to the DoD Chief Financial Officer by June 30, 1994. The audit report is required to contain an opinion on whether the financial statements are presented in all material aspects in accordance with applicable accounting standards and an evaluation of internal controls and compliance with applicable laws and regulations. On March 8, 1994, we received the DLA FY 1993 financial statements dated February 2, 1994.

## **Objectives**

The objectives of the audit were to determine whether the property, plant, and equipment and associated depreciation accounts on the FY 1993 financial statements were presented fairly in accordance with generally accepted accounting principles. We were also to evaluate the internal control structure for those accounts and to assess compliance with applicable laws and

regulations for those transactions and events that have a direct and material effect on the property, plant, and equipment and associated depreciation accounts.

## **Scope and Methodology**

This audit is one of a series of audits being conducted in response to the Chief Financial Officers Act of 1990, which requires an annual audit of the financial statements of revolving funds, such as the DBOF. The audit was performed in conjunction with audits of the DLA's management data (Report No. 94-128); inventory accounts (Report No. 94-150); and fund balances with the Treasury accounts (Project No. 4LE-2001) for the FY 1993 financial statements.

The audit evaluated the reasonableness of the property, plant, and equipment and associated depreciation accounts, as reflected on the Statement of Financial Position and related Footnotes to the Principle Statements for the DLA DBOF business areas for FY 1993. The following table displays the reported assets and the amounts reviewed.

**Property, Plant, and Equipment and Depreciation Accounts Reviewed  
(million)**

<u>Business Area</u>	<u>Acquisition Cost</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value Reported</u>
Clothing Factory	\$ 10.6	\$ 8.2	\$ 2.4
Distribution Depots*	120.1	65.2	54.9
Industrial Plant Equipment	0.3	0.2	0.1
Reutilization and Marketing*	88.1	9.8	78.3
Supply Management*	<u>99.4</u>	<u>38.9</u>	<u>60.5</u>
Total DLA	<u>\$318.6</u>	<u>\$122.3</u>	<u>\$196.3</u>
Total*	<u>\$307.6</u>	<u>\$113.9</u>	<u>\$193.7</u>

\*Business areas audited

For our audit tests, we used two-stage or three-stage statistical samples of sites and assets for each of the three largest business areas; that is the distribution depots, reutilization and marketing services, and supply management. The three areas reviewed showed a net balance of \$193.7 million in the DLA Property, Plant, and Equipment Account and represented 98.7 percent of the net capital assets reported. The sample was provided by our Quantitative Methods Division. Specifics relating to the sampling techniques used are contained in Appendix B.

## **Introduction**

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This financial statement audit was performed from September 1993 through March 1994, in accordance with the generally accepted auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, Department of Defense; Office of Management and Budget Bulletin No. 93-06, "Audit Requirement for Federal Financial Statements," January 8, 1993; and "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," January 12, 1994. The audit included such tests of internal controls as were considered necessary. We analyzed asset data available from manual and computer reports used by DLA and DFAS to report the values of property, plant, and equipment. The audit included verifying the reliability of computer-processed data on the property, plant, and equipment accounts, as discussed in Part II of the report. A complete list of the organizations visited or contacted during the audit is in Appendix D.

## **Internal Controls**

**Controls Assessed.** We evaluated internal controls applicable to regulations and procedures that DLA business areas used to manage and control asset accountability and to report capital assets. We also evaluated the process by which DLA and DFAS implemented the DoD Internal Management Control Program as it relates to capital asset accounting.

**DoD Internal Management Control Program.** The DoD Annual Statement of Assurance for FY 1993 identified a continuing problem with the financial management systems of DoD. The annual statement of assurance reported deficiencies in some internal controls, including property, plant, and equipment, but concluded that the control deficiencies were not of sufficient materiality to impede or endanger the Department's ability to accomplish policy and mission objectives.

**Internal Control Weaknesses.** The audit identified material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. The same internal control weaknesses were identified in previous audit reports. Internal controls were not adequate to ensure the accurate reporting of the property, plant, and equipment and associated depreciation accounts on the financial records. DFAS recognized and reported its inability to produce reliable financial statement data in its FY 1993 annual statement as required by the DoD Internal Management Control Program. Recommendations A.1. and A.2., if implemented, will help correct the internal control weaknesses. No monetary benefits are associated with the internal control weaknesses. However, correcting the internal control weaknesses should significantly improve the accuracy of reported financial data.

A copy of the final report will be provided to senior officials responsible for internal controls within the Office of the Secretary of Defense, DFAS, and DLA.

## **Prior Audits and Other Reviews**

During the last 3 years, the Inspector General, DoD, has issued two audit reports relating to the Chief Financial Officers Act addressing the property, plant, and equipment accounts. The audit reports are summarized below.

Inspector General, DoD, Report No. 94-035, "Financial Reporting Procedures For Defense Distribution Depots - Defense Logistics Agency Business Area of the Defense Business Operations Fund," February 8, 1994, identified significant weaknesses in internal controls that affect the reliability of financial data presented in financial statements. The report also identified the property, plant, and equipment account for FY 1992 as being significantly understated, because not all capital assets had been reported. The DoD Deputy Comptroller (Management Systems) commented that property used by DBOF activities should be reported as an asset on the financial statement of the using activity.

Inspector General, DoD, Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," June 30, 1993, identified material weaknesses in the internal control structure of the DBOF, as related to capital asset accounting. The report stated that depreciation schedules were incorrectly developed because Army personnel did not record correct information and did not have an accounting system to compute depreciation. Another reason given was that Air Force personnel did not depreciate assets over the assets' useful life. Additionally, transactions were not executed in compliance with existing guidance; and reconciliations were not performed. The DoD Acting Chief Financial Officer generally agreed with the report and indicated that corrective actions would be implemented.

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## **Part II - Findings and Recommendations**

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## **Finding A. Property, Plant, and Equipment**

Acquisition costs of property, plant, and equipment accounts in the DLA FY 1993 Financial Statements were materially understated by at least \$229.4 million. The condition occurred because:

- o DLA did not comply with the DoD policy for capital asset accounting and reporting.
- o DLA lacked controls to ensure the accuracy and completeness of property, plant, and equipment financial data.

As a result, inaccuracies in the financial data were reported to higher authority and the usefulness of the statements was adversely affected.

### **Background**

The Comptroller of the DoD memorandum, "Capital Asset Accounting Guidance for the Defense Business Operations Fund," July 21, 1992, provides policy for capital asset recognition, accounting, and depreciation. Capital assets include, but are not limited to, physical plant and property (including minor construction), equipment, and software. The criteria for asset recognition were an expected useful life of 2 or more years and an acquisition cost of \$15,000 or more. For assets purchased during FY 1994 and after, the dollar threshold was increased to \$25,000.

DFAS is responsible for developing and establishing accounting procedures needed to implement DoD policy. To implement the Comptroller of the DoD guidance, DFAS created a personal computer data base system called the Capital Asset Database (CAD). Each business area is to provide DFAS specified data on each capital asset. DFAS enters the data into the CAD and the system calculates monthly depreciation. DFAS then enters the CAD calculations into appropriate automated accounting systems. The CAD is a system designed to serve as an interim means of solving the reported high risk area of poor accountability and reporting of capital assets in DoD. Until an improved system is developed, DFAS will use the CAD, in conjunction with the management of the DBOF business areas, for recording financial information on property, plant, and equipment.

DFAS also provides accounting services to the DLA business areas and prepares the financial statements required by the Chief Financial Officers Act. The business areas are responsible for providing DFAS the necessary data and for the accuracy of data entered into the financial system. DFAS prepares the financial statements; however, the accuracy of the statements is principally DLA's responsibility.

## Finding A. Property, Plant, and Equipment

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### Misstatements of Property, Plant, and Equipment Values

The property, plant, and equipment and associated depreciation accounts reported on the FY 1993 financial statements were materially misstated. We identified unrecorded capitol assets resulting in a net understatement of the acquisition cost of DLA's property, plant, and equipment account of \$229.4 million (\$153.9 million for real property and \$75.5 million for equipment). In addition, at least \$24.5 million in equipment assets were inaccurately reflected in the financial records because they had not been recorded as equipment assets, had been fully depreciated, had been disposed of, or belonged to another entity. We attributed the condition to noncompliance with DoD guidance and inadequate internal controls.

### Compliance with DoD Capital Asset Guidance

The DLA business areas were not in compliance with the Comptroller of the DoD guidance on the capitalization and financial reporting of real property assets. The Comptroller's capital asset accounting guidance requires DBOF activities to capitalize all assets, including real property and minor construction projects, that meet the capitalization criteria, and those for which they can substantiate preponderant use in the production of goods or services for their customers. DLA had taken no action to report all real property capital assets and real property assets were understated by at least \$153.9 million. The following paragraphs describe the extent of nonreporting by DLA business areas.

**Distribution Depot and Supply Management.** The distribution depot and supply management business areas did not attempt to comply with the Comptroller of the DoD guidance on real property asset capitalization and financial statement reporting. To illustrate, three distribution depot facilities, valued in total at \$140.4 million, that were recently constructed at San Joaquin, California, and Susquehanna, Pennsylvania, distribution depot complexes, were not included in the financial statements. Additionally, the supply management business area failed to report at least 63 real property facilities, valued at \$15.4 million, at 3 activities (the Defense Construction Supply Center, the Defense General Supply Center, and the Defense Personnel Support Center).

Instead of complying with the Comptroller of the DoD guidance, the business areas stated in a footnote, "...real property is not capitalized by this DBOF business area because United States Code, Title 10 provides that real property facilities that DoD agencies use shall be under the jurisdiction of the Military Departments." The business areas' interpretation of the provisions of title 10 was incorrect because the provisions of title 10 addressed ownership of real property, not financial recognition by users. Generally accepted accounting principles and Comptroller of the DoD guidance require recognition of the value of real property used by the business areas in providing their services.

## Finding A. Property, Plant, and Equipment

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**Reutilization and Marketing.** The reutilization and marketing business area attempted to comply with the Comptroller's guidance on capitalization of construction projects. However, misstatements occurred because the business area continued to report assets that were no longer in its possession. Real property improvements and construction, valued at \$1.9 million, at 10 reutilization offices that had discontinued operations were still reflected in the financial statements.

## Adequacy of Internal Controls

The three DLA business areas reviewed had not established effective internal controls to validate the accuracy and completeness of property, plant, and equipment financial data. Because the three DLA business areas did not reconcile their equipment property records to the financial records established by DFAS, inaccuracies in the data were not identified and corrected. The accounting records did not reflect at least \$75.5 million of equipment assets and another \$24.5 million were inaccurately reported or categorized. The results of our sample verification and other non-sample observations on the accuracy of the equipment assets reported in the FY 1993 financial statements are discussed below, by business area.

**Distribution Depots.** Of the 250 sample items we reviewed, valued at \$31.5 million, 111 items, valued at \$6.9 million, were inaccurately reflected on the financial records, primarily because the items had not been recorded as equipment assets on the records; had been fully depreciated; or had been disposed of. For example, at the Distribution Depot-Red River, Texas, a tractor valued at \$174,948 was recorded as an asset even though the tractor had been turned in for disposal in May 1993.

Additionally, the Defense Distribution Region East reported only \$17.7 million in property, plant, and equipment for the distribution facilities in its reporting region. Region management decided not to comply with the DFAS asset reporting procedures because inputting the assets into the CAD would require too many resources. To illustrate the significance of the region's decision not to report its assets, the acquisition value of the material handling equipment at the Distribution Depot-Susquehanna, alone, was about \$75.5 million.

**Reutilization and Marketing.** Of the 232 sample items, valued at \$9.5 million, at 36 reutilization offices, 10 items, valued at \$0.2 million, were improperly reflected on financial records. While the sample results indicated no material misstatement, other reviews of assets reported in the financial records disclosed errors, such as multiple entries for the same equipment items, depreciation of assets even though the asset had been fully depreciated, and the absence of other assets that were on hand and on property records. We identified 87 other non-sample equipment assets, valued at \$3.3 million, that were inaccurately reported in the financial records.

**Supply Management.** Of the 164 sample items, valued at \$18.9 million, 99, valued at \$14.1 million, were improperly reflected in the financial system primarily because the assets belonged to other entities. For example, at the Defense Construction Supply Center, 31 sample items, valued at \$3.9 million, were shown as belonging to the Defense Construction Supply Center when the assets actually belonged to 14 different Defense Reutilization and Marketing Offices.

## **Recommendations, Management Comments, and Audit Response**

### **1. We recommend that the Director, Defense Logistics Agency:**

- a. Establish procedures to ensure that the Defense Logistics Agency business areas comply with the existing DoD policy for capital asset accounting and reporting.
- b. Establish internal control procedures that require Defense Logistics Agency business areas to perform periodic reconciliations of the property, plant, and equipment financial data to property records to ensure that the account balances reflected on financial records are accurate.

### **2. We recommend that the Director, Defense Logistics Agency, and the Director, Defense Finance and Accounting Service, revise the FY 1993 financial statements to show the effect of appropriately capitalizing assets and disclose in the footnotes to the revised statements the problems identified in the audit.**

**Management Comments.** DLA concurred with Recommendations 1.a. and 1.b. and stated that procedures to correct the problems would be in place by the publication date of the FY 1994 financial statements.

DLA partially concurred and the Defense Finance and Accounting Service nonconcurred with Recommendation 2., stating that because the FY 1993 financial statements had already been certified and published, corrections to the account balances would be disclosed in the FY 1994 statements.

**Audit Response.** DLA's comments to Recommendations 1.a. and 1.b. are responsive.

DLA and the Defense Finance and Accounting Service's agreement to disclose corrections to account balances in the FY 1994 financial statements is an acceptable alternative to Recommendation 2.

## **Finding A. Property, Plant, and Equipment**

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### **Additional Management Comments and Audit Response**

**Management Comments.** DLA provided additional comments to the finding. DLA stated that the Inspector General, DoD, Report No. 94-035, "Financial Reporting Procedures for Defense Distribution Depots - Defense Logistics Agency Business Area of the Defense Business Operations Fund," February 8, 1994, specified that the Services should report real property rather than DBOF activities. DLA was attempting to comply with the report at the time financial statements were prepared. However, the General Accounting Office ruled that assets should be reported by the business activity that benefits from the assets. DLA stated that \$153.9 million of the understatement was a result of the interpretation to not report real property. DLA intends to report real property on the FY 1994 financial statements. The complete text of management comments is in Part IV.

**Audit Response.** The cited report specifically stated that the issue on proper accounting for real property assets needed to be resolved. In response to that report, the General Accounting Office ruled on the issue and the DoD Deputy Comptroller (Management Systems) reiterated that property used by DBOF activities to produce goods or services and to earn revenue should be reported as an asset on the financial statements of those activities.

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## **Finding B. Depreciation of Major Software Programs**

The useful life that DoD established for the depreciation of major software programs did not provide for the proper matching of period expenses with revenues and overstated the cost of operations. The condition occurred because the Comptroller of the DoD guidance required that DBOF activities depreciate all software programs over a 5-year period without considering the assets' projected useful life. As a result, major software programs will be fully depreciated before their economic life has expired, and the accelerated depreciation of the programs would result in overcharging military unit customers by more than \$417 million in the early years of program implementation.

### **Background**

One of the primary purposes for creating the DBOF was to fully identify and ultimately reduce military support activities' operating costs through increased efficiencies. DBOF activities are required to recover all operating costs and depreciation of capital assets is a significant cost of doing business. DBOF operating costs are recovered by including the costs in customer rates for providing goods or services.

On July 21, 1992, the Comptroller of the DoD issued a memorandum, "Capital Asset Accounting Guidance for the Defense Business Operations Fund." The guidance provided new and expanded policy for capital asset accounting and depreciation of capital assets in the DBOF. The policy was established to provide consistent procedures for the DBOF activities to identify and recover the full cost of their operations. The capital asset guidance requires each DBOF activity to depreciate the value of its capital assets, including software programs, used in providing goods or services to its customers. Depreciation is intended to allocate the cost of capital assets as an operating expense during the period in which the assets are to provide benefits. DBOF activities are required to calculate and accumulate depreciation using a straight-line method, that is, the capitalized amount is to be divided equally among accounting periods over a designated number of years. DoD guidance provides the depreciation period for different categories of assets and requires that computer equipment and the associated software systems be depreciated over a 5-year period.

## **Finding B. Depreciation of Major Software Programs**

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### **Depreciation Criteria**

DoD guidance resulted in inappropriate depreciation of software programs and it did not properly match period expenses with revenues, as required by generally accepted accounting principles. As a result, during the initial 5 years of software program implementations, military unit customers will be overcharged for the depreciation of DBOF software programs.

**Software Developments.** In conjunction with the DoD Corporate Information Management efforts to upgrade many of the DoD information systems, DBOF activities are expending hundreds of millions of dollars on the development and implementation of major new software programs. Generally, software programs of this magnitude are expected to provide an extended period of benefit to the users. DoD Instruction 7041.3, "Economic Analysis and Program Evaluation for Resource Management," October 18, 1972, requires activities to perform an economic analysis for such major programs. The analysis is a systematic approach to the problem of choosing how to employ scarce resources in the most efficient and effective manner. Each analysis is required to contain specific data elements, such as objectives of the program, total cost to develop and implement the program, and its projected economic or useful life. To match costs with revenues during a period, generally accepted accounting principles require capital assets to be depreciated over their expected useful life.

**Depreciation Periods.** In compliance with the Comptroller of the DoD capital asset guidance, DBOF activities are required to depreciate software programs over a 5-year period instead of their projected economic or useful life. When we asked the Comptroller of the DoD management officials why they established a 5-year period for depreciation of software systems, they could not provide any supporting analysis or documentation. Comptroller officials stated that they believed that 5 years was an accepted industry average and that they wanted to ensure consistency in depreciation periods. Our review of the economic analyses prepared for several major software developments disclosed that the expected useful life significantly exceeded five years. The economic analyses generally showed that the systems' life cycle (the period that extends from the time of initial obligation of funds through the end of the systems' useful life) was 13 years. The normal life cycle for major developments indicated a 3-year system development phase until full operational capability was obtained, then a 10-year operational or useful life phase.

## Cost Impact of Accelerated Depreciation

The depreciation of software programs over 5 years instead of 10 years or useful life results in accelerated depreciation of costs and overcharging military unit customers of the DBOF during the early periods of software program implementation.

**Systems Review.** We obtained the economic analyses for software development efforts for three major DoD logistics systems involving materiel distribution, depot maintenance, and supply management. DLA was in the process of developing a major system for its distribution depot area, and the Joint Logistics System Center was responsible for developing several new systems in the logistics areas of depot maintenance and supply management. DLA provided us with the economic analysis for the distribution depot development, the Distribution Standard System. Personnel from the Joint Logistics System Center were asked to provide the economic analyses for the Depot Maintenance Standard System and the Material Management Standard System.

An overall economic analysis for the Depot Maintenance Standard System was not available. The Depot Maintenance Standard System consisted of six subsystems, for which only four had an economic analysis. The four subsystems with an economic analysis were the Depot Maintenance Hazardous Material Management System, Depot Maintenance Management Information System, Programmed Depot Maintenance Scheduling System, and Tool Information Management Application. Conversely, the Joint Logistics Systems Center provided an economic analysis for the overall Material Management Standard System instead of an economic analysis for each of the subsystems of this area. The total projected cost of the systems cited in the DLA and Joint Logistics Systems Center economic analyses, consisting primarily of hardware, software, and operational and maintenance costs, was \$18.4 billion. Excluding the hardware and projected operational and maintenance costs of the systems, the net software development costs for capitalization and depreciation was about \$1.2 billion.

The subsystems selected for review represented only a small portion of DoD's overall efforts to increase military effectiveness with fewer resources, by streamlining its business practices and standardizing the supporting information systems. With the exception of the Programmed Depot Maintenance Scheduling System, the subsystems have not been fully developed and will be implemented on an incremental basis at various times throughout the next 6 years, the Future Years Defense Program (FYDP) period (FY 1995 through FY 2000).

## Finding B. Depreciation of Major Software Programs

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**Comparison of Depreciation Costs.** Using the DoD established 5-year period for depreciating major software systems, rather than the systems' expected useful life, substantially accelerated the depreciation of the systems. The accelerated depreciation overstates costs in the early years of the system, and the overstated costs would be passed on to the customers being supported by DBOF activities. To illustrate, we compared the depreciation cost that would be passed on to supported activities through surcharge rates over the FYDP (FY 1995 through FY 2000) for the Material Management Standard System using the Comptroller's 5-year criteria compared to the costs using the system's estimated useful life. The total projected cost of the system was \$4.5 billion, and the system was expected to reach full operating capability by FY 1997. Excluding \$3.687 billion in costs for hardware and projected operation and maintenance of the system, the estimated cost of the software to be capitalized and depreciated was \$813 million. During the FYDP, \$746.6 million of the \$813 million total software costs would have been incurred, and, based on program implementation, depreciation costs initiated. Because of phased implementation of modular systems, depreciation costs would vary in individual years of the FYDP. Overall during the FYDP, depreciation of the software development costs using the 5-year DoD criteria would equate to costs of \$568 million. However, using the estimated useful life basis of 9 years, the costs incurred for depreciation would total only \$315.6 million during the FYDP. The difference of \$252.4 million over the FYDP (FY 1995 through FY 2000) represents a decrease in DBOF operating costs that military units would not have to pay for when ordering material from the DBOF logistics business areas.

Calculations of excessive costs to be charged the DBOF customers for the six systems we reviewed using the software systems' expected useful life for depreciation versus the Comptroller's criteria are shown in the following table.

## Finding B. Depreciation of Major Software Programs

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### Depreciation Costs Over the 6-Year Future Years Defense Program (FY 1995 through FY 2000) (million)

System <sup>1</sup>	Costs	Useful Life <sup>2</sup>	Depreciation Costs		
			DoD Criteria	Useful Life Criteria	Excess Costs <sup>3</sup>
DSS	\$ 315.0	10	\$259.18	\$144.30	\$114.88
DM-HMMS	1.9	12	.65	.27	.38
DMMIS	109.9	12	82.15	34.23	47.92
PDMSS	4.1	12	2.83	2.05	.78
TIMA	1.3	12	1.03	.43	.60
MMSS	813.0	9	568.02	315.57	252.45
Total	<u>\$1,245.2</u>		<u>\$913.86</u>	<u>\$496.85</u>	<u>\$417.01</u>

<sup>1</sup>Systems

DSS Distribution Standard System.

DM-HMMS Depot Maintenance Hazardous Material Management System.

DMMIS Depot Maintenance Management Information System.

PDMSS Programmed Depot Maintenance Scheduling System.

TIMA Tool Information Management Application.

MMSS Material Management Standard System.

<sup>2</sup>Useful life in years taken from the economic analysis prepared to justify the system over its life cycle.

<sup>3</sup>Difference between depreciation costs during the Future Years Defense Program (FY 1995 through FY 2000) based on the 5-year criteria versus the system expected useful life.

As shown above, use of the Comptroller of the DoD guidance will result in the DBOF activities significantly overstating their cost of operation during the early years of software program implementation, and thereby, overcharging their customers. For the six systems we reviewed, using the system useful life for depreciation purposes would reduce, by \$417 million, the costs that would be passed on to and paid by military customers of the DBOF. The six systems we reviewed represent only a small number of the total number of systems being developed. There are many more systems being developed for which the depreciation period should be changed to a useful life basis.

## Recommendation, Management Comments, and Audit Response

We recommend that the Comptroller of the Department of Defense revise the capital asset guidance for the depreciation of major software programs to require that DBOF activities depreciate programs over the estimated useful life shown in the economic analysis.

## **Finding B. Depreciation of Major Software Programs**

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**Management Comments.** The Deputy Comptroller for Financial Systems agreed in principle with the recommendation. The Deputy Comptroller stated that the application of depreciation within the DBOF should conform with standard DoD policy and generally accepted accounting practices and that the current policy on depreciation of software programs is being reviewed by the DBOF Corporate Board. Upon completion of the review, the policy on software depreciation will either be reaffirmed or an alternative policy will be proposed.

**Audit Response.** The Deputy Comptroller's comments are generally responsive. However, the comments did not provide an estimated completion date for the review of software depreciation and a statement on the potential monetary benefits. We request that the Deputy Comptroller provide an estimated completion date of the review by the DBOF Corporate Board and comments on the potential monetary benefits.

## **Part III - Additional Information**

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## Appendix A. Reported Property, Plant, and Equipment Accounts

**Defense Logistics Agency  
Defense Business Operations Fund Business Areas'  
FY 1993 Consolidated and Principal Statements' Property, Plant, and  
Equipment Accounts**

<u>Business Area</u>	<u>Acquisition Value</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>
<b><u>Consolidated DLA</u></b>			
Facilities	\$ 2,483,107	\$ 846,552	\$ 1,636,555
ADP Software	10,931,112	5,712,146	5,218,966
Equipment	<u>305,158,136</u>	<u>115,759,023</u>	<u>189,399,113</u>
Total	<u>\$318,572,355</u>	<u>\$122,317,721</u>	<u>\$196,254,634</u>
<b><u>Clothing Factory</u></b>			
Facilities	\$ 0	\$ 0	\$ 0
ADP Software	0	0	0
Equipment	<u>10,624,759</u>	<u>8,201,093</u>	<u>2,423,666</u>
Total	<u>\$10,624,759</u>	<u>\$8,201,093</u>	<u>\$2,423,666</u>
<b><u>Defense Reutilization and Marketing Service</u></b>			
Facilities	\$ 0	\$ 0	\$ 0
ADP Software	0	0	0
Equipment	<u>88,090,342</u>	<u>9,817,186</u>	<u>78,273,156</u>
Total	<u>\$88,090,342</u>	<u>\$9,817,186</u>	<u>\$78,273,156</u>
<b><u>Distribution Depots</u></b>			
Facilities	\$ 676,831	\$ 103,990	\$ 572,841
ADP Software	7,106,560	4,057,863	3,048,697
Equipment	<u>112,295,419</u>	<u>61,001,462</u>	<u>51,293,958</u>
Total	<u>\$120,078,810</u>	<u>\$65,163,315</u>	<u>\$54,915,496</u>
<b><u>Industrial Plant Equipment</u></b>			
Facilities	\$ 0	\$ 0	\$ 0
ADP Software	0	0	\$0
Equipment	<u>348,775</u>	<u>256,035</u>	<u>92,740</u>
Total	<u>\$348,775</u>	<u>\$256,035</u>	<u>\$92,740</u>
<b><u>Supply Management</u></b>			
Facilities	\$ 1,806,276	\$ 742,562	\$ 1,063,714
ADP Software	3,824,552	1,654,283	2,170,269
Equipment	<u>93,798,841</u>	<u>36,483,247</u>	<u>57,315,594</u>
Total	<u>\$99,429,699</u>	<u>\$38,880,092</u>	<u>\$60,549,576</u>

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## **Appendix B. Audit Site Selection, Audit Sample Methodology, and Projections**

**Capital Asset Universe.** The distribution depot, reutilization and marketing, and supply management, DLA business areas provided data identifying all their operating sites and equipment recognized for capitalization and depreciation. The clothing factory and industrial plant equipment business areas were excluded because of their relatively small size. Additionally, the clothing factory business area was destined for closure in FY 1994. Because of the lack of complete and uniform reporting by each of the business areas, we adjusted our sample of items within each business area to compensate for the differences between the business areas. The three business areas' data indicated that 237 sites with 4,966 equipment items existed at an acquisition cost of \$269.8 million, as shown in Table B.1.

**Table B.1. Audit Universe for Reviewed Business Areas**

<u>Business Area</u>	<u>No. Sites</u>	<u>No. Items</u>	<u>Acquisition Cost (million)</u>
Distribution Depots	26	2,302	\$ 135.91
Reutilization and Marketing	193	1,294	51.72
Supply Management	18	1,370	82.23
Total	<u>237</u>	<u>4,966</u>	<u>\$269.8</u>

<sup>1</sup> Exceeds the amount reported by \$15.8 million primarily because the database provided to us included assets not in use.

<sup>2</sup> Includes only equipment because of the lack of uniform reporting of facilities and software assets. The \$88.1 million (Appendix A) reported by DLA as only equipment included \$30.6 million of facilities, \$5.8 million of automated data processing equipment, and \$51.7 million of equipment items.

<sup>3</sup> The database provided to us could only support \$82.2 million in supply management assets.

**Sampling Plan.** To verify the existence and use of identified capital assets, we used a multistage sampling plan that incorporated both cluster and stratified sampling methodologies. The audit sample included 50 sites. For the chosen sites, we selected 131 equipment items acquired at \$44.0 million for items valued over \$100,000 each (stratum 1) and 515 equipment items acquired at \$15.9 million for items valued between \$15,000 and \$99,999 (stratum 2). The random sample represented 21 percent of the sites, 13 percent of the equipment items, and 23 percent of the acquisition cost. Table B.2. shows the random sample by business area.

## Appendix B. Audit Site Selection, Audit Sample Methodology, and Projections

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**Table B.2. Audit Random Sample for Reviewed Business Areas**

<b>Business Area</b>	No. <u>Sites</u>	<b>Stratum 1</b>		<b>Stratum 2</b>	
		No. <u>Items</u>	Acquisition <u>Costs</u> (million)	No. <u>Items</u>	Acquisition <u>Costs</u> (million)
Distribution Depots	10	52	\$25.3	198	\$ 6.2
Reutilization and Marketing	36	17	3.0	215	6.5
Supply Management	4	62	15.7	102	3.2
Total	<u>50</u>	<u>131</u>	<u>\$44.0</u>	<u>515</u>	<u>\$15.9</u>

**Distribution Depots Business Area.** We statistically selected 10 of 26 depots for review. The selected depots in the eastern region were Anniston, Alabama; Charleston, South Carolina; Cherry Point, North Carolina; Jacksonville, Florida; and Letterkenny, Pennsylvania. Of the eastern region depots we selected, Charleston, Cherry Point, and Letterkenny reported no assets; however, we selected a random sample from installation property records. The depots selected for the western region were Barstow, California; McClellan, California; Oklahoma City, Oklahoma; Puget Sound, Washington; and Red River, Texas. For the 10 selected depots, we selected a sample of 250 reported items, acquired for \$31.5 million, from a total universe for 26 depots of 2,302 reported items with an acquisition value of \$135.9 million.

**Reutilization and Marketing Business Area.** We statistically selected 36 of the 193 sites for review. The reutilization and marketing business area had the largest sample of sites, with 8 in the eastern region, 10 in the western region, 12 in the European region, and 6 in the Pacific region. The six Pacific sites were not visited; however, property records from those sites were obtained and compared to capital asset records. Of the six Pacific sites, two did not respond to our inquiries for records. The 36 sites selected involved a sample of 232 reported items, acquired for \$9.5 million, from a total universe for 193 sites of 1,294 reported items with an acquisition value of \$51.7 million.

**Supply Management Business Area.** We statistically selected four of the six supply management centers for review. The centers were the Defense Construction Supply Center, the Defense General Supply Center, the Defense Industrial Supply Center, and the Defense Personnel Supply Center. The 4 centers reported 1,250 of the 1,370 items reported by the supply management business area and \$61.7 million of the \$82.2 million of the cost for equipment. For the 4 selected centers, a sample of 164 items acquired at \$18.9 million was selected for review.

**Sample Results.** Overall, our sample included 646 items acquired at \$59.9 million. Results of the sample review indicated that 220 items were inappropriately reflected in the capital asset accounts at an acquisition cost of \$21.2 million. Results by business area are shown in Table B.3. below.

## **Appendix B. Audit Site Selection, Audit Sample Methodology, and Projections**

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**Table B.3. Audit Random Sample Results**

<u>Business Area</u>	<u>Sample</u>		<u>Errors</u>	
	No. <u>Items</u>	Acquisition <u>cost</u> (million)	No. <u>Items</u>	Acquisition <u>cost</u> (million)
Distribution Depots	250	\$31.5	111	\$ 6.9
Reutilization and Marketing	232	9.5	10	0.2
Supply Management	164	18.9	99	14.1
Total	<u>646</u>	<u>\$59.9</u>	<u>220</u>	<u>\$21.2</u>

**Projections.** The projections of the sample of equipment items statistically selected for review will be provided to DLA by letter at a later date because of the congressional mandate to provide the DoD Chief Financial Officer the results of the audit by June 30, 1994. Additionally, the value of errors identified for the sample items were insignificant in light of the materiality of the nonreporting of real property assets.

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## **Appendix C. Summary of Potential Benefits Resulting From Audit**

<b>Recommendation Reference</b>	<b>Description of Benefit</b>	<b>Amount and/or Type of Benefit</b>
A.1. and A.2.	Compliance and Internal Control. Improve accuracy for reporting and accounting for capital assets.	Nonmonetary
B.	Economy and Efficiency. Decreased depreciation charges would decrease operations costs.	Funds put to better use.* We estimated that potential monetary benefits of about \$417 million for the 6-year FYDP (FY 1995 through FY 2000) could be obtained through the revision of the capital asset guidance.

\*The potential monetary benefits were based on savings to DoD military units from reduced depreciation charges for selected software programs. The Comptroller of the DoD guidance would require charging \$913.9 million during the FYDP (FY 1995 through FY 2000). A revised depreciation policy would require charging only \$496.9 million during the same period. The useful life policy would allow the DoD military customers to realize the difference of \$417 million in charges. After a new policy on software depreciation is issued, the potential monetary benefits may change.

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## **Appendix D. Organizations Visited or Contacted**

### **Office of the Secretary of Defense**

Office of the Deputy Under Secretary of Defense for Logistics, Washington, DC  
Office of the Deputy Comptroller of the Department of Defense (Management Systems), Washington, DC

### **Department of the Army**

U. S. Army Depot System Command, Chambersburg, PA  
U. S. Army Corps of Engineers, Sacramento, CA

### **Defense Organizations**

Headquarters, Defense Finance and Accounting Service, Washington, DC  
Defense Finance and Accounting Service, Columbus, OH  
    Defense Finance and Accounting Service, Columbus, Battle Creek, MI  
    Defense Finance and Accounting Service, Columbus, Ogden, UT  
    Defense Finance and Accounting Service, Columbus, Philadelphia, PA  
    Defense Finance and Accounting Service, Columbus, Richmond, VA

Headquarters, Defense Logistics Agency, Alexandria, VA  
Distribution Depot Region East, New Cumberland, PA

Distribution Depots:  
    Anniston, AL  
    Charleston, SC  
    Cherry Point, NC  
    Jacksonville, FL  
    Letterkenny, PA

Distribution Depot Region West, Stockton, CA

Distribution Depots:  
    Barstow, CA  
    McClellan, CA  
    Oklahoma City, OK  
    Puget Sound, WA  
    Red River, TX

Defense Construction Supply Center, Columbus, OH  
Defense General Supply Center, Richmond, VA  
Defense Industrial Supply Center, Philadelphia, PA

# **DRAFT AUDIT REPORT FOR OFFICIAL USE ONLY**

## **Appendix D. Organizations Visited or Contacted**

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### **Defense Organizations (cont'd)**

Defense Personnel Support Center, Philadelphia, PA

Defense Cold Storage Facility, Kaiserslautern, Germany

Headquarters, Defense Reutilization and Marketing Service, Battle Creek, MI

Defense Reutilization and Marketing Service, National Sales Office, Memphis, TN,

Defense Reutilization and Marketing Service, Region East, Columbus, OH

Defense Reutilization and Marketing Offices, Region East:

Berlin, Germany

Cecil Field, FL

Chievres, Belgium

Fort Belvoir, VA

Giessen, Germany

Hanau, Germany

Kaiserslautern, Germany

Kastel, Germany

Keesler Air Force Base, MS

Lajes, Portugal

Livorno, Italy

Mayport, FL

Nuremburg, Germany

Patrick Air Force Base, FL

Pensacola, FL

Quantico, VA

Rota, Spain

Schweinfurt, Germany

Tampa, FL

Vicenza, Italy

Defense Reutilization and Marketing Service, Region West, Ogden, UT

Defense Reutilization and Marketing Offices, Region West:

Bupyong, Korea

Fort Ord, CA

Guam

Iwakuni, Japan

Mare Island, CA

Misawa, Japan

Okinawa, Japan

Oklahoma City, OK

Port Hueneme, CA

Pusan, Korea

Scott Air Force Base, IL

Sheppard Air Force Base, TX

Stockton, CA

Travis Air Force Base, CA

Vandenberg Air Force Base, CA

Whiteman Air Force Base, MO

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## **Appendix E. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology  
Comptroller of the Department of Defense  
Assistant to the Secretary of Defense (Public Affairs)

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Auditor General, Naval Audit Service

### **Department of the Air Force**

Auditor General, Air Force Audit Agency

### **Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Finance and Accounting Service  
Director, Defense Logistics Agency  
Director, National Security Agency  
Inspector General, Central Imagery Office  
Inspector General, Defense Intelligence Agency  
Inspector General, National Security Agency  
Director, Defense Logistics Studies Information Exchange

### **Non-Defense Federal Organizations**

Office of Management and Budget  
U.S. General Accounting Office  
National Security and International Affairs Division, Technical Information Center  
National Security and International Affairs Division, Defense and National  
Aeronautics and Space Administration Management Issues  
National Security and International Affairs Division, Military Operations and  
Capabilities Issues

## **Appendix E. Report Distribution**

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### **Non-Defense Federal Organizations (cont'd)**

Chairman and Ranking Minority Member of each of the following Congressional Committees and Subcommittees:

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
Senate Subcommittee on Oversight of Government Management, Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Operations  
House Subcommittee on Legislation and National Security, Committee on Government Operations

## **Part IV - Management Comments**

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# Office of the Comptroller of the Department of Defense Comments



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

JUN 3-- 1994

## MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Audit Report on Property, Plant and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993 (Project No. 3LD-2023)

This memorandum is in response to your memorandum of May 17, 1994, requesting comments on the subject draft audit report on the property, plant and equipment accounts of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund.

Due to the restricted time available to reply to the draft audit report, this response is limited to the recommendation directed to the Comptroller, DoD. A more comprehensive response will be provided in response to the final report.

The Department agrees in principle that the application of depreciation within the Defense Business Operations Fund (DBOF) should conform with standard DoD policy and other relevant factors, including generally accepted accounting practices. The Department also recognizes that determining the period of depreciation for any individual piece of software involves some judgment that must consider a number of different factors, including the estimated physical life. The Department, through the policy subcommittee of the DBOF Corporate Board, is reviewing the Department's current policy regarding the depreciation period for software. Upon completion of its review, the policy subcommittee is expected to either reaffirm the current DoD policy or propose an alternative policy to the DBOF Corporate Board. As a participant on the DBOF Corporate Board, the ODO DIG will have an opportunity to participate in this decision process.

My point of contact on this draft audit report is Mr. John Glover. He may be reached at (703) 697-0537 or DSN 227-0537.

*Richard F. Keeley*  
Richard F. Keeley  
Deputy Comptroller  
(Financial Systems)

# Defense Finance and Accounting Service Comments



## DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY  
ARLINGTON, VA 22240-5291

DFAS-HQ/AD

JUN 2 1994

### MEMORANDUM FOR DIRECTOR, LOGISTICS SUPPORT DIRECTORATE INSPECTOR GENERAL, DOD

SUBJECT: DoDIG Draft Audit Report, "Property, Plant, and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," (Project No. JLD-2023)

We have reviewed the subject draft report and have a management comment concerning recommendation A.2. We nonconcur with the recommendation to revise the FY 1993 financial statements to show the effect of appropriately capitalizing assets and disclose in the footnotes to the revised statements the problems identified in the audit.

The financial statements for FY 1993 have been certified and published, therefore, revision to show "the effect" of the DoDIG audit can not be accomplished. If the data in the Capital Asset Database is inaccurate and results in the misstatement of account balances in the trial balance, the database should be corrected. Journal vouchers with complete backup documentation would then be processed in Appropriated Accounting Subsystem and the corrective actions would be disclosed in the FY 1994 financial statements.

My point of contact concerning these management comments is Mr. David C. Morton. He may be reached at (703) 607-1581/1579 or DSN 327-1581/1579

Daniel Turner  
Deputy Director for Business Funds

# Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY  
HEADQUARTERS  
CAMERON STATION  
ALEXANDRIA, VIRGINIA 22304-6100



IN REPLY  
REFERRED TO DDAI

108 JUN 1994

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,  
DEPARTMENT OF DEFENSE

SUBJECT: OIG Draft Report on "The Property, Plant and Equipment  
Accounts on the Financial Statements of the Defense  
Business Operations Fund," (Project No. 3LD-2023)

This is in response to your 17 May 1994 request.

1 Encl

cc:  
FO

*Jacqueline G. Bryant*  
JACQUELINE G. BRYANT  
Chief, Internal Review Office

TYPE OF REPORT: Audit

PURPOSE OF INPUT: Initial Position      DATE OF POSITION:

AUDIT TITLE & NUMBER: *Property, Plant and Equipment Accounts on the Financial Statements of the DLA Business Areas of the DBOF for FY 93 (Project No. 3LD-2023)*

FINDING A: Property, Plant and Equipment. Acquisition costs of property, plant and equipment accounts in the DLA FY 1993 Financial Statements were materially understated by at least \$229.4 million. The condition occurred because:

- 1) DLA did not comply with the DoD policy for capital asset accounting and reporting.
- 2) DLA lacked controls to ensure the accuracy and completeness of property, plant and equipment financial data.

As a result, inaccuracies in the financial data were reported to higher authority and the usefulness of the statements was adversely affected.

DLA COMMENTS: Concur, however we do have the following comment.

As you know, the issue of who should report real property that the Military Services "permit" to the Defense agencies was unresolved at the time the financial statements were prepared. Your previous position on this issue was that the Military Services should report the property. In your report issued on 8 February 1994 (Report No. 94-035), you explicitly wrote, "Thus, the Military Services, not DLA, should report the distribution depots' real property". You also held this position in your report on the FY 1992 DBOF Principal and Combining Statements (Report No. 93-134). When the financial statements were prepared, we were attempting to comply with your position. To put this finding in perspective - of the \$229.4 million understatement identified in your finding, \$153.9 million or 67 percent of the understatement was related to real property.

Now that the GAO has ruled on this issue and you've clarified your position, we intend to report real property on the FY 1994 financial statements.

## Defense Logistics Agency Comments

TYPE OF REPORT: Audit

PURPOSE OF INPUT: Initial Position      DATE OF POSITION:

AUDIT TITLE & NUMBER: *Property, Plant and Equipment Accounts on the Financial Statements of the DLA Business Areas of the DBOF for FY 93 (Project No. 3LD-2023)*

RECOMMENDATION A.1: Recommend that the Director, Defense Logistics Agency business areas comply with existing DoD policy for capital asset accounting and reporting; and establish internal control procedures that require Defense Logistics Agency business areas to perform periodic reconciliations of the property, plant and equipment financial data to property records to ensure that the account balances reflected on financial records are accurate.

DLA COMMENTS: Concur. As we stated in our comments to the finding, now that the real property policy issue has been resolved, we intend to report real property on the FY 1994 financial statements. We also agree that property, plant, and equipment financial data should be periodically reconciled to property records.

DISPOSITION:

(x) Action is Ongoing. Estimated completion Date: Publication date of the FY 1994 financial statements.  
( ) Action is Considered Complete.

INTERNAL MANAGEMENT CONTROL WEAKNESSES:

( ) Nonconcur  
(x) Concur; however weakness is not considered material  
( ) Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance

MONETARY BENEFITS:

DLA COMMENTS:

ESTIMATED REALIZATION DATE:

AMOUNT REALIZED:

DATE BENEFITS REALIZED

ACTION OFFICER: Richard Sninsky, FOX, x46481, 31 May 94  
PSE REVIEW/APPROVAL: Michael F. Miller for J. S. Rountree, CHPT,

Acting Chief Financial Officer, 2 Jun 94  
Jim O'Laughlin, FOX, x46100, 31 May 94

COORDINATION:

L. Coulter, DDATI, 2 Jun 94

DLA APPROVAL:

*A. Rems for J. Bryant, 2 Jun 94*

7 JUN 1994

  
LAWRENCE P. FARRELL, JR.  
Major General, USAF

Defense Logistics Agency Comments

**DISPOSITION:**

- (x) Action is Ongoing. Estimated Completion Date: Publication date of the FY 1994 financial statements.  
( ) Action is Considered Complete

**INTERNAL MANAGEMENT CONTROL WEAKNESSES:**

- ( ) Nonconcur  
(x) Concur; however weakness is not considered material  
( ) Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance

**ACTION OFFICER:** Richard Sninsky, FOX, x46481, 31 May 94

**PSC REVIEW/APPROVAL:** Michael F. Miller for J. S. Rountree, CAPT,  
Acting Chief Financial Officer, 2 Jun 94

**COORDINATION:** Jim O'Laughlin, FOX, x46100, 31 May 94

La Coulter, DDAI, 2 Jun 94

**DLA APPROVAL:** *As Requested for J. Biggs, 2 Jun 94*

7 JUN 1994



LAWRENCE F. FARRELL, JR.  
Major General, USAF  
Principal Deputy Director

## Defense Logistics Agency Comments

TYPE OF REPORT: AUDIT

PURPOSE OF INPUT: INITIAL POSITION DATE OF POSITION:

AUDIT TITLE AND NO: *Property, Plant and Equipment Accounts on the Financial Statements of the DLA Business Areas of the DBOF For FY93 (Project No. 3LD-2023)*

RECOMMENDATION A.2: Recommend that the Director, Defense Logistics Agency, revise the FY93 financial statements to show the effect of appropriately capitalizing assets and disclose in the footnotes to the revised statements the problems identified in the audit.

DLA COMMENTS: Partially concur. We agree that the footnotes should disclose the problems you identified in the audit. However, for practical, cost/benefit, and administrative reasons, we will not revise the FY 1993 financial statements or footnotes. Unfortunately, the timing of the CFO due dates do not make adjustments to the financial statements and/or footnotes feasible at this juncture. When the FY 1994 financial statements are prepared, we intend to report real property, accurate equipment data, and disclose known problems.

DISPOSITION:

(x) Action is Ongoing. Estimated Completion Date: Publication date of the FY 1994 financial statements.  
( ) Action is Considered Completion.

INTERNAL MANAGEMENT CONTROL WEAKNESSES:

( ) Nonconcur  
(x) Concur; however, weakness is not considered material  
( ) Concur; weakness is material and will be reported in the DLA Annual statement of Assurance

MONETARY BENEFITS:

DLA COMMENTS:

ESTIMATED REALIZATION DATE:

AMOUNT REALIZED:

DATE BENEFITS REALIZED:

ACTION OFFICER: Richard Sninsky, FOX, x46481, 31 May 94  
PSM REVIEW/APPROVAL: Michael F. Miller for J. S. Rountree, CAPT,

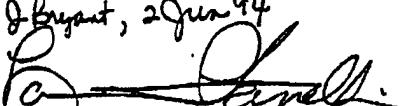
Acting Chief Financial Officer, 2 Jun 94

COORDINATION: Jim O'Laughlin, FOX, x46100, 31 May 94

L. Coulter, DDAI, 2 Jun 94  
*I believe for J. Bryant, 2 Jun 94*

DLA APPROVAL:

7 JUN 1994

  
LAWRENCE P. FARRELL, JR.  
Major General USAF  
Principal Deputy Director

## **Audit Team Members**

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